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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1949

No.

BROWN SHOE COMPANY, INC.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,

Respondent

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

The petitioner, Brown Shoe Company, Inc., hereinafter referred to as the taxpayer, prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Eighth Circuit entered on June 17, 1949, in the above entitled cause and in the cause entitled *Commissioner of Internal Revenue* v. *Brown Shoe Company, Inc.*, which were heard on a consolidated record.

Opinion Below

The opinion of the Tax Court (R. 23-26) is reported in 10 T.C. 291. The opinion of the Court of Appeals (R. 148-160) is reported in 175 F. (2d) 305 (advance sheets).

Jurisdiction

The judgment of the Court of Appeals was entered on June 17, 1949 (R. 161). Taxpayer's petition for rehearing was denied by the Court of Appeals on August 8, 1949 (R. 167). The jurisdiction of this Court is invoked under Title 28, U. S. Code, Section 1254.

Questions Presented

1. Is the amount of $971,031.01, representing cash and property received by the taxpayer from various community groups as an inducement to locate a new plant or enlarge an existing plant in the particular community, includable in taxpayer's equity invested capital, either as a "contribution to capital" within the meaning of Section 718(a)(1) and (2) of the Internal Revenue Code, or as part of its "accumulated earnings and profits" within the meaning of Section 718(a) (4) of the Internal Revenue Code?

2. Does the cash in the amount of $885,559.45, received by the taxpayer from the community groups and deposited in its unrestricted bank account, reduce the taxpayer's "basis" for depreciation of buildings and machinery and equipment constructed or acquired by the taxpayer in the respective communities?

3. Is the taxpayer entitled to deduct depreciation on the two factory buildings which it received directly from two of the community groups, the said buildings having stipulated bases of $20,251.93 and $65,219.63, respectively?

Statute and Regulations Involved

The pertinent provisions of the statute and regulations are printed in the Appendix, *infra*, pages 23-32.

Statement

This proceeding involves deficiencies in taxpayer's excess profits tax for the fiscal years ended October 31, 1942 and October 31, 1943. The facts have been fully stipulated (R. 27-123, 129) and may be summarized as follows:

The taxpayer is a corporation organized and existing under the laws of the state of New York with its principal office at St. Louis, Missouri. It is engaged in the business of manufacturing and selling at wholesale men's, women's and children's shoes, conducting its operation in a number of different plants located in the states of Missouri, Illinois, Indiana and Tennessee (R. 24, 27, 28).

During the period from 1914 up to October, 1939, the taxpayer received $885,559.45 in cash and $85,471.56 (stipulated value) in buildings from various community groups as an inducement to locate a new plant, or enlarge an existing plant, in the particular community, the total amounting to $971,031.01 (R. 24, 28, 29). In all cases except one there were contracts between the taxpayer and the respective community groups. These contracts varied, but generally required the taxpayer to construct a new factory, or enlarge an existing factory, in the particular community, operate it for an agreed period of time, meet a specified payroll during the agreed period of time and employ a stipulated number of employees. In ten instances the amount was to be refunded, or the factory building erected was to be transferred, to the particular community group if the taxpayer failed to comply with the terms of the contract (R. 24). In one instance involving the payment to the taxpayer of $10,000 cash, there was no contract with the community group; the minutes of the meeting of the taxpayer's Board of Directors merely state that a "bonus" of $10,000 had been paid "as a part of our organization expenses in starting the factory" in Dixon, Illinois (R. 28). In six

instances the agreements between the taxpayer and the respective community groups contain no obligation for any repayment of the funds, or transfer of the property. The amounts involved in those six instances totaled $102,006.65 (R. 39, 41-47, 69, 71-73, 99, 108-109). In one of them, cash of $10,000 was paid to the taxpayer "as evidence of the good-will this community has toward you" (R. 108, 109).

In all cases the money or property involved was transferred or paid over to the taxpayer outright.[1] The stipulated period, provided for in eleven of the contracts, during which the taxpayer was to operate the plant and meet the other conditions specified, had expired in all but four contracts involving property and cash totalling $190,471.56 (R. 28, 29, 35-109).

After the taxpayer had complied with all of the terms of the respective contracts, it was free to operate the factories in any way it desired or to dispose of them and to retain the proceeds without any obligation to account to the contributing groups (R. 28-30, Exs. 1-A to 16-P, R. 35-109). The Tax Court assumed, and was correct in so doing, that the

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[1] In this respect the situation is different from that involved in *Frank Holton & Co.*, 10 B.T.A. 1317, decided under the earlier excess profits tax law and relied upon by the Tax Court in the instant case, because in that case title to the property had not passed to the taxpayer and was to be transferred to it only after it had met certain obligations. Such transfer had not taken place on the date which was determinative for the computation of invested capital.

The situation of the taxpayer in the instant case is also different from that involved in *C. L. Downey Co.* v. *Commissioner*, 172 F. (2d) 810, relied upon by the Court of Appeals. There, a Chamber of Commerce had advanced money to the company for which the company executed its note with the understanding that the company would be relieved of the necessity of repayment if it complied with certain stipulated obligations concerning the operation of the factory. These obligations had not been met at the critical date. The company contended for the inclusion of the amount in invested capital as "borrowed capital" under Sections 717 and 719 of the Internal Revenue Code, and not as part of its equity invested capital under Section 718, I.R.C.

taxpayer had fulfilled all conditions attached to the transfers (R. 24).

When received from the community groups, the cash was deposited in taxpayer's general bank account, out of which it paid the cost of constructing the buildings and additions and the cost of the machinery and equipment for the factories in the particular communities. The cash received by the taxpayer from a particular group "was not earmarked for or held intact and applied against the cost of factory, machinery, equipment and other items applicable to the plant acquired or constructed in the particular community". The cash payments when received from the community groups were credited to its earned surplus accounts, either directly or after they had first been credited to contributed surplus. (R. 30, 31, 113, 114.)

The values of the two buildings received from the community groups and used in taxpayer's trade or business, during the taxable years here involved, were set up in the building account on the asset side of its balance sheet and were credited directly to the surplus account on the liability side (R. 30, 31, 114). The parties have stipulated that the bases of the two buildings, for the purpose of inclusion in invested capital and for the computation of depreciation, were $20,251.93 and $65,219.63, respectively (R. 32).

The taxpayer found it necessary to train new employees for employment in the new or enlarged factories in the communities from which it received the contributions. The cost of training such new employees was not less than $100 for each new employee. Before the new or enlarged factories could be operated, the taxpayer had to supply them with an opening inventory of the materials necessary for the manufacturing of shoes. The parties have stipulated the cost of training the new employees, the cost of the opening inventory, the cost of the buildings,

cost of machinery, and the cost of land (in instances where land was purchased) for each of the new or enlarged factories in the communities from which it received the contributions (R. 32, 33, 119).

In every instance the cash which the taxpayer received from the community groups was less than the amount which it expended for the construction of the factory buildings and for machinery and equipment with which to operate the said factories (R. 31). At all times material to the issues in this case, the taxpayer had "accumulated earnings and profits" in excess of $971,031.01 (R. 129).

In computing its excess profits net income for the two taxable years here involved, the taxpayer deducted depreciation on the two buildings received directly from the community groups and also on the full cost of its new and enlarged plants in the communities from which it had received cash contributions. The Commissioner of Internal Revenue disallowed the deduction for depreciation on the two buildings which taxpayer had received directly from the community groups, and he also disallowed an additional amount which he determined to be depreciation on the portion of the buildings, machinery and equipment acquired with cash received from the community groups. The Commissioner also reduced taxpayer's equity invested capital by the amount of $971,031.01, representing the cash and the agreed value of the buildings received from the community groups in question (R. 31, 32).

The Tax Court sustained the Commissioner's determination (a) in reducing taxpayer's equity invested capital by the amount of $971,031.01 on the ground that the said sum did not constitute part of taxpayer's "accumulated earnings and profits" nor part of its invested capital because the transferors were not stockholders (R. 24, 25), and (b) in disallowing depreciation on the two buildings received

directly from the community groups (R. 25). However, the Tax Court held that the Commissioner was not justified in disallowing depreciation on a portion of the cost of the buildings, machinery and equipment constructed or acquired by the taxpayer in the communities from which it had received cash contributions. The Tax Court found that the taxpayer had paid for the said buildings, machinery and equipment out of its own unrestricted funds, and that those items had "cost" to the taxpayer for the purpose of depreciation (R. 25, 26).

Both parties filed petitions for review. On the Commissioner's petition, the Court of Appeals reversed the Tax Court's finding, based upon a stipulation of fact, that the buildings, machinery and equipment constructed or acquired by the taxpayer in the communities from which it had received cash contributions, had "cost" to the taxpayer of the amounts which it had expended therefor, and held that the Tax Court's finding on this point was clearly erroneous within the meaning of Rule 52(a) of the Federal Rules of Civil Procedure (R. 152-155).

On the taxpayer's petition, the Court of Appeals held that the amount of $971,031.01 was not includable in equity invested capital either as "accumulated earnings and profits" or as a "contribution to capital," and also held that the taxpayer was not entitled to depreciation on the two buildings which it had received directly from two of the community groups (R. 155-160).

Specification of Errors to Be Urged

The Court below erred:

1. In holding that the amount of $971,031.01, representing cash and property previously received by the taxpayer from

the community groups, is not includable in taxpayer's equity invested capital as money and property paid in as a "contribution to capital" within the meaning of Section 718(a)(1) and (2), I.R.C.

2. In holding that the said amount of $971,031.01 is not includable in taxpayer's invested capital as part of its "accumulated earnings and profits" within the meaning of Section 718(a)(4), I.R.C.

3. In holding that the taxpayer was not entitled to a deduction for depreciation on the two buildings which it had received directly from two community groups.

4. In setting aside as "clearly erroneous" the findings of the Tax Court to the effect that the taxpayer had a "cost" basis for depreciation equivalent to the total cost of the buildings constructed by it and machinery and equipment acquired by it in the communities from which it had received cash contributions in the aggregate amount of $885,559.45.

5. In holding that the taxpayer's "basis" for depreciation of the buildings constructed by it and the machinery and equipment acquired by it for use in the factories in the communities from which it had received cash contributions, must be reduced by the amount of the cash contributions, as determined by the Commissioner of Internal Revenue.

6. In failing to pass upon taxpayer's alternative contention that if the cash contributions received from the various communities are to be treated, for tax purposes, as a repayment of a portion of taxpayer's cost of starting the factory in the particular community, then the contribution should be allocated not only to the cost of land, buildings, machinery and equipment, but also to the cost of

training new employees and the cost of providing opening inventories with which to operate the factories.[2]

7. In entering judgment for the Commissioner in the two appeals before the Court.

Reasons for Granting the Writ

1. The instant case presents squarely the broad question of the proper treatment, for Federal income and excess profits tax purposes, of contributions received by corporate business enterprises from the Government, or a political subdivision thereof, or community groups, as an inducement to locate and operate a plant or to construct a railway. The number of corporate business enterprises which have received such contributions is large and continues to grow.[3]

These corporations, including railroads which have received a land grant or contributions from communities or community groups, are confronted with a host of unsettled questions in the field of Federal taxation: Whether such money or property is includable in its invested capital; whether property, if of a kind normally subject to depreciation or depletion, may be included in the tax-

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[2] This contention was raised before the Tax Court (R. 8, 9) but was not decided by that Court since it decided the principal depreciation issue in favor of the taxpayer. It was urged before the Court of Appeals (R. 164) but that Court failed to pass upon it.

[3] This taxpayer alone received not less than seventeen different contributions over a period of twenty-five years (1914-1939) (R. 28, 29). *McKay Products Corporation*, 9 T.C. 1082, involves a like contribution received in 1935, and *C. L. Downey Co.* v. *Commissioner*, 172 F. (2d) 810, involves a transaction of the same general nature entered into in 1941. In the case of railroads, such "donations" are encountered, in the form of land grants or contributions from local communities, so frequently that the Interstate Commerce Commission found it necessary to promulgate rules concerning their accounting treatment. See instructions No. 606 and No. 754, Uniform System of Accounting for Steam Railways, "Accounting Classification", effective January 1, 1942.

payer's basis for depreciation or depletion; whether depreciable property acquired with cash so received or with other cash of its own pursuant to the conditions of the contract with the contributing group is subject to depreciation; and whether a distribution made by such a corporation to its stockholders would constitute a taxable dividend under the provisions of Section 115 of the Internal Revenue Code, if the corporation had no surplus available for distribution other than the surplus created by the contributions here under consideration.

The instant case offers an opportunity for an authoritative decision by this Court on each of these questions.[4] The wide implications of the problems presented by the instant case are indicated by the cases involving various phases of the question, which have already reached the courts, and which reflect the doubts with regard to their proper tax treatment. Whether such contributions were includable in the invested capital of the recipient corporation under the earlier 1918 and 1921 excess profits tax laws was before the United States Board of Tax Appeals in *Frank Holton & Co.*, 10 B. T. A. 1317. A somewhat related question arising out of the same general factual situation was before the United States Court of Appeals for the Eighth Circuit in *C. L. Downey Company* v. *Commissioner*, 172 F. (2d) 810, and questions substantially identical with those involved in the instant case are now pending before the Court of Appeals for the Third Circuit in an appeal from a

[4] A decision in this case, though it does not directly concern the question of whether such a distribution would be a taxable dividend, would supply the answer, since the question turns on "accumulated earnings and profits" within the meaning of Section 115, I.R.C., and since, pursuant to Section 728, I.R.C., the term "accumulated earnings and profits" as used in Section 718(a)(4) has the same meaning as the like term used in Section 115 of the Internal Revenue Code. *Commissioner* v. *South Texas Lumber Co.*, 333 U. S. 496, 500 (footnote 7).

decision of the Tax Court in *McKay Products Corporation*, 9 T. C. 1082. Numerous other cases involving the same basic question are still pending before the Bureau of Internal Revenue, many of which are bound to reach the courts unless the question is finally settled by this Court.

2. In holding that the contributions received by the taxpayer from community groups do not constitute a "contribution to capital" within the meaning of Section 718(a)(1) and (2) of the Internal Revenue Code, the court below has decided an important Federal question in conflict with the decision of this Court in *Edwards* v. *Cuba Railroad Co.*, 268 U. S. 628. In that case, this Court held that subsidies of land, physical property and money paid by the Government of Cuba for the construction of railroads in consideration of which the railroad was to construct a line, reduce certain tariffs and render certain services free of charge, were not income to the railroad company but were contributions to its capital assets. Later, in *Texas & Pacific Railway Co.* v *United States*, 286 U. S. 285, this Court contrasted the payments received by a railroad company under the Transportation Act of 1920 with the contributions received by the taxpayer in the *Cuba Railroad Co.* case, *supra*, stating (p. 289):

> "The sums received under the act [Transportation Act of 1920] were not subsidies or gifts,—that is, *contributions to the capital of the railroads*,—and this fact distinguishes cases such as Edwards v. Cuba R. Co., 268 U. S. 628, where the payments were conditioned upon construction work performed. * * *". (Italics supplied.)

The court below was obviously doubtful of its decision on this point but decided the question against the taxpayer on the ground that it could not say that the decision of the Tax Court was clearly erroneous, stating (R. 160):

> * * * Until the Supreme Court has construed the 1940 Act otherwise we cannot say that the decision of the Tax Court in this regard is clearly erroneous."

When the term "contribution to capital" was introduced into the income tax law by Section 113(a)(8) of the Revenue Act of 1932 (c. 209, 47 Stat. 169),[5] Congress was obviously familiar with the *Cuba Railroad Co.* case, and it can be safely assumed that the term was used in the same sense and that it was intended to apply to contributions such as those involved in the *Cuba Railroad Co.* case. Indeed, it would be difficult to find a more common, and at the same time a better, example of "contributions to capital" than those involved in the *Cuba Railroad Co.* case and in the instant case. It is well established that "unless the contrary appears, statutory words are presumed to be used in the ordinary and usual sense, and with the meaning commonly attributed to them". *DeGanay* v. *Lederer*, 250 U. S. 376, 381. The nature of the contributions which this taxpayer received, and the obligations which it assumed in consideration thereof are substantially identical with those involved in the *Cuba Railroad Co.* case. The decision of the court below is in conflict with the definition of "contribution to capital" as used by this Court in *Edwards* v. *Cuba Railroad Co.*, *supra*, and as that decision was interpreted by this Court in *Texas & Pacific Railway Co.* v. *United States*, *supra*.

3. In approving the Tax Court's holding that contributions such as those involved in the instant case are not includable in invested capital under Section 718(a)(1) and (2) because they were not made by stockholders, the lower

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[5] The term was used in the corresponding section of succeeding Revenue Acts and of the Internal Revenue Code; in 1940 it was introduced in the excess profits tax law of 1940 (Section 718(a)(1) and (2), I.R.C.). See Appendix, *infra*, pages 23, 24, 27, 28.

court has nullified the Commissioner's definition of the term "contribution to capital" in Regulations which under well established principles must be regarded as having received Congressional approval.

The Tax Court held that the contributions here involved did not become part of equity invested capital under Section 718(a)(1) or (2) because the transferors were not stockholders (R. 25).

The Court of Appeals for the Eighth Circuit pointed out that the Tax Court's decision in this regard was consistent with the decision of this Court in *LaBelle Iron Works* v. *United States*, 256 U. S. 377, decided under the 1917 Act, and upheld the Tax Court because it could not say that the decision of the Tax Court in this regard was clearly erroneous. The definition of invested capital under the 1917 Act was entirely different from the definition of invested capital under the Second Revenue Act of 1940. In the 1917 Act, invested capital was defined as "(1) actual cash paid in, (2) the actual cash value of tangible property paid in other than cash, for stock or shares in such corporation * * * and (3) paid-in or earned surplus and undivided profits used or employed in the business, * * *" (1917 Revenue Act, Sec. 207(a); c. 63, 40 Stat. 300).[6]

That definition of invested capital was changed in Section 718 (a)(1), (2) and (4) of the Internal Revenue Code[7] to include money or property "paid in for stock, or as paid in surplus, or *as a contribution to capital*"; plus the accumulated earnings and profits as of the beginning of the taxable year.[8] As previously mentioned (p. 12 *supra*),

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[6] The definition of invested capital in Section 326(a) of the 1918 and 1921 Revenue Acts (c. 18, 40 Stat. 1057; c. 136, 42 Stat. 227) was substantially the same as the definition in the 1917 Act.

[7] The text of these provisions is set out in the Appendix, *infra*, pp. 26-28.

[8] It also provided, for the first time, for the inclusion, in invested capital, of borrowed capital. Sections 717, 719, I.R.C.

the term "contribution to capital", when first used by Congress as a component of equity invested capital in the Second Revenue Act of 1940, had a well defined meaning in the income tax law and regulations. It had been used in the income tax law itself for a period of eight years, and had been defined in the Commissioner's income tax regulations for a period of more than six years. The clear meaning of the term as defined in the Commissioner's income tax regulations was money or property contributed to the corporation by "any person"—not only a shareholder. Reenactment of the statute without disapproval of regulations thereunder gives the regulations added sanction.[9]

The term was first introduced in income tax law as a part of Section 113(a)(8) of the Revenue Act of 1932 and has been retained in each succeeding revenue act and in the corresponding section of the Internal Revenue Code up to the present time.

The Commissioner defined the term in Income Tax Regulations 86 (Article 113(a)(8)-1), promulgated under the Revenue Act of 1934, as follows:

> "In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, *or from any person as a contribution to capital*, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift, the basis thereof shall be determined under section 113(a)(2)." (Italics supplied.)

The above provision has been included in all of the subsequent income tax regulations, including the present Regu-

[9] *Commissioner* v. *Wheeler*, 324 U. S. 542, 547 (footnote 10).

lations 111, as an interpretation of Section 113(a)(8) of the law.[10]

The excess profits tax Regulations 109 and 112, promulgated by the Commissioner under the excess profits tax act of 1940,[11] contained a definition of the term "contribution to capital" practically identical with the definition contained in the income tax regulations. Sections 30.718-1, and 35.718-1).[12]

The holding of the Tax Court, as approved by the Court of Appeals, that the contributions here involved do not constitute part of taxpayer's equity invested capital because they were not made by stockholders, is counter to and nullifies these provisions of the Commissioner's regulations. This situation will necessarily result in great confusion in the administration of Section 113(a)(8) and will lead to additional litigation unless the question of what constitutes, and who can make, a contribution to capital is decided by this Court.[13]

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[10] Regulations 94 (Article 113(a)(8)-1), promulgated under the Revenue Act of 1936; Regulations 101 (Article 113(a)(8)-1), promulgated under the Revenue Act of 1938; Regulations 103 (Sec. 19.113(a)(8)-1) and Regulations 111 (Sec. 29.113(a)(8)-1), promulgated under the Internal Revenue Code, the latter Regulations being applicable to all taxable years beginning after December 31, 1941.

[11] Applicable, respectively, to taxable years beginning prior to, and after, December 31, 1941.

[12] The text of these provisions is set out in the Appendix, *infra*, pp. 30-31.

[13] The excess profits tax law of 1940 having been passed "to tax abnormally high profits due to large governmental expenditures about to be made from appropriations for national defense" (*Commissioner* v. *South Texas Lumber Co.*, *supra*, at 497), the result reached by the courts below is incongruous because it subjects to excess profits tax, gains which have nothing whatsoever to do with war profits or abnormally high profits, and which, indeed, are normal profits. By eliminating the contributions of $971,031.01 from taxpayer's invested capital, the courts below have reduced what Congress deemed to be a taxpayer's "fair and normal return for the corporation business taxed". (*Commissioner* v. *South Texas Lumber Co.*, *supra*, at 497). Here, such "fair and normal return" was

4. The question of whether contributions of the nature of those here involved constitute "accumulated earnings and profits" within the meaning of Section 718(a)(4), I.R.C., irrespective of whether or not they constituted taxable income at the time of their receipt, is of great practical importance for the purpose of determining invested capital under the recent excess profits tax law and, as well, "earnings and profits" available for distribution of dividends under Section 115(a), I.R.C. Although this Court had repeatedly dealt with "earnings and profits", the cases always concerned rather narrowly defined aspects, and in none of the cases, so far as we have found, was the question squarely presented, as does the instant case, of what constitutes earnings and profits, and in particular, of whether items not subject to income tax are includable in "earnings and profits".[14] This Court has dealt, for instance, with questions concerning the tax treatment of pre-March 1, 1913, accumulations;[15] with distributions in con-

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represented by a percentage of its invested capital, and the smaller the invested capital; the smaller is the amount deductible from the net income as excess profits credit.

If the taxpayer had computed its excess profits tax by the use of the excess profits credit based on income, such credit would be measured by the earnings during the base period years from all of its assets, *no matter from whom received*. Congress obviously did not intend to discriminate against taxpayers using the invested capital method. It seems reasonable to conclude that under either method all "working capital" was to be used in determining the standard of normal earnings. In the *South Texas Lumber Co.* case (at pages 497, 498) this Court stated:

> "It thus appears that by this [invested capital] method Congress intended, with minor exceptions not here relevant, to impose the excess profits tax on all annual net income in excess of 8% of a corporation's working capital • • •"

[14] The record fails to indicate whether the taxpayer was taxed on the contributions here involved. The courts below assumed that they were not taxable income in taxpayer's hand, and the taxpayer does not contend to the contrary. The entire amount was received subsequent to March 1, 1913, so that no problem of a pre-March 1, 1913 accumulation is involved.

[15] *Lynch* v. *Hornby*, 247 U. S. 339; *Peabody* v. *Eisner*, 247 U. S. 347; *Heivering* v. *Canfield*, 291 U. S. 163; and *Foster* v. *United States*, 303 U. S. 118.

nection with liquidations [16] and reorganizations; [17] with earnings and profits of a corporation reporting income on the installment basis,[18] and with the question of whether a dividend was distributed out of profits of the year 1917 or an earlier year.[19]

In holding that its decision was controlled by *Commissioner* v. *South Texas Lumber Co.*, *supra* (R. 157-158), the lower court failed to appreciate that that case is limited to corporations reporting on the installment basis under Section 44 of the Internal Revenue Code and the regulations promulgated thereunder, and that the validity of those regulations was "the crucial question" (333 U. S. at p. 500). However, that case did not hold that an item must have constituted taxable income in order to be includable in "earnings and profits."

The lower court's holding that the amount of $971,031.01 was not includable in taxpayer's "earnings and profits" because it had not been included in taxable income in the years of receipt, has in effect nullified Section 29.115-3 of Regulations 111 and corresponding section of the earlier regulations.[20] That regulation promulgated under Section 115 of the Internal Revenue Code specifically provides that "earnings and profits" of a corporation include "all income exempted by Statute, income not taxable by the Federal government under the Constitution, * * * interest on State bonds and certain other obligations although not taxable when received by a corporation * * *". The effect of the lower court's decision on this point is to exclude from the

[16] *Lynch* v. *Turrish*, 247 U. S. 221; *Commissioner* v. *Wheeler*, 324 U. S. 542.

[17] *Commissioner* v. *Bedford*, 325 U. S. 283; *Commissioner* v. *Munter*, 331 U. S. 210; *Commissioner* v. *Phipps*, 336 U. S. 410; several of those cases involve the application of the Sansome rule (60 F. (2d) 931).

[18] *Commissioner* v. *South Texas Lumber Co.*, supra.

[19] *Edwards* v. *Douglas*, 269 U. S. 204.

[20] The text of these sections is set out in Appendix, *infra*, pp. 29, 30.

invested capital of a corporation all exempt income included in its accumulated earnings and profits. Likewise, it would have the effect of excluding surplus created by the receipt of such exempt income or contributions of the nature here involved from taxable dividends when distributed to the shareholders of the corporation.

If such items are not part of accumulated earnings and profits under Section 718(a)(4), which by Section 728, I.R.C., is given the same meaning as earnings and profits under Section 115 of the Internal Revenue Code,[21] they would not constitute taxable income to the stockholders when distributed. Thus, in excluding such items from earnings and profits in order to eliminate them from invested capital for the relatively short period of the second excess profits tax, the lower court has set a precedent which would exempt from tax for the indefinite future all such items when the surplus created by their receipt is distributed to the shareholders.

Early in the history of the present income tax law, this Court established a broad meaning for "dividends," as "the appropriate fruit of stock ownership . . . commonly reckoned as income," without regard to whether they are declared "from the most recent earnings, or from surplus accumulated from the earnings of the past or are based upon the increased value of the property of the corporation."[22] The holding of the court below would tend to narrow the concept of "earnings and profits" and, therefore, of taxable dividends. A decision of this Court on this ques-

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[21] See Sec. 35.718-2 of Treasury Regulations 112 (Appendix, *infra*, p. 31). Under the law of the State of New York, the state in which the taxpayer is incorporated (Section 58 of the Stock Corporation Law, Appendix, *infra*, p. 31), the taxpayer would have been free to distribute the surplus created by the receipt of the contributions in question if its Board of Directors had desired to do so. *Randall* v. *Bailey*, 23 N.Y.S. (2d) 173; affirmed, 288 N.Y. 280, 43 N.E. (2d) 43.

[22] *Lynch* v. *Hornby*, 247 U. S. 339, 344.

tion would be of great practical importance in the administration of the internal revenue laws, and would forestall much future litigation.

5. The decision of the lower courts on the depreciation issues presented in this case and in other cases involving the right of the taxpayer to deduct depreciation on property directly contributed by a community group or purchased with money contributed by such a group, reflects the extreme confusion existing on the subject. The instant case presents squarely the depreciation issues arising out of such a situation and is, therefore, an appropriate one in which this Court could finally resolve the doubts and obviate much future litigation.

Although the facts in the instant case are clearly different from the facts in *Detroit Edison Co.* v. *Commissioner*, 319 U. S. 98, the lower courts have relied mainly on that case, in deciding the depreciation questions. The contributors toward the cost of the extensions in the *Detroit Edison* case were making payments in exchange for a direct personal benefit—namely, the extension of the line to the home or place of business of the particular contributor. After the extension had been made, he had a continuing interest in it, and the utility company was not free to discontinue the service. This Court held that the payments made to the Detroit Edison Company by the prospective users were not gifts or contributions to capital, but that they "were to the customer the price of the service." Consequently, those payments which had not been taxed as income reduced the cost of the extension to the utility company for depreciation purposes.

On the other hand, neither the community group nor its individual members expect or receive any direct benefit. They make the contribution for the benefit of the entire community, because by attracting a new enterprise

or inducing an existing one to enlarge its operations, the community group secures a source of additional employment for the population of that particular community.

Every court which had occasion to pass on the depreciation issues of the kind here involved, has held that no depreciation could be taken on property contributed by a community group to a taxpayer, and with one exception, every court has held that in determining the basis for depreciation, a taxpayer's cost had to be reduced by the cash received from community groups. The only exception was the holding of the Tax Court in the instant case. Although disallowing depreciation on the two contributed buildings, the Tax Court (R. 25, 26) found that this taxpayer could deduct depreciation on buildings, machinery and equipment, that their cost was what it had expended for these items, and that the basis for depreciation should not be reduced by the amount of the cash contributions received from community groups. However, this finding, though plainly justified by the record (Stipulations 9, 11, R. 30 to 32), was reversed by the Court of Appeals as being "clearly erroneous." The Court relied on a condition found in some, but not all, of the contracts with the community groups that the cash contributed was to be used for the payment of a factory building and the equipment (R. 154). However, the Court overlooked the fact that in one instance there was no contract and, consequently, no condition of any sort; that in other instances there was no condition that the money be used for the construction and equipment of a factory, and that in all instances where the contracts contained such a condition, they also required the taxpayer to do many other things. It is significant that the same Judge of the Tax Court (Judge Murdock), who made the finding in the taxpayer's case, made an opposite finding in the case of *C. L. Downey Company*, 10 T. C. 837.

where a Chamber of Commerce had paid that taxpayer money to be applied toward the construction of a plant in the particular community. In that case, he found that the money received from the Chamber of Commerce was not part of the basis for depreciation of the plant in question.

The *Downey* decision was affirmed in *C. L. Downey Co. v. Commissioner*, 172 F.(2d) 810, on the ground that depreciation "is allowable only on the cost to the taxpayer of property," ignoring completely the exceptions to the use of the cost basis, enumerated in Section 113(a), I.R.C. In *McKay Products Corporation*, 9 T.C. 1082, the Tax Court stated that the buildings received by that taxpayer did not constitute a gift under Section 113(a)(2), I.R.C., and, consequently, had no basis for purposes of depreciation.

The effect of the decisions of the lower courts is to nullify completely the provisions of Section 113(a)(2) and Section 113(a)(8)(B), I.R.C., which provide that a taxpayer may use the basis of the transferor where property is received as a gift or as a contribution to capital. They reached that conclusion by construing the decision of this Court in the *Detroit-Edison Company* case as if it had abrogated every subparagraph of Section 113(a) and had held that cost to the taxpayer is the only basis for depreciation. The same construction is being applied by the Bureau of Internal Revenue.

If the contributions in the instant case were received as "contributions to capital", as the taxpayer contends, then the taxpayer is entitled to the transferor's basis for the purpose of computing depreciation—otherwise, Section 113(a)(8)(B) is meaningless. The transferor's basis in the case of the two buildings received directly from the community groups has been stipulated and the cash received directly from the community groups has a "basis" in the hands of the transferor equivalent to the cash received.

An authoritative decision by this Court on the depreciation questions involved in the instant case would dispel the confusion now existing in the minds of taxpayers and, as well, the lower courts; would aid in the administration of the tax laws, and would avoid much future litigation.

Conclusion

The decision below is wrong; it invalidates in effect two provisions of the Treasury regulations; it is in conflict with decisions of this Court; and it involves questions which are recurring and of great importance in the administration of the federal tax laws. For the foregoing reasons, the petition for a writ of *certiorari* should be granted.

Respectfully submitted,

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APPENDIX

Statutes and Regulations Applicable During the Taxable Years Ending October 31, 1942, and October 31, 1943.

Internal Revenue Code:

Sec. 23. Deductions from Gross Income.

In computing net income there shall be allowed as deductions:

* * * * * * * * *

(l) [as amended by Sec. 121(c), Revenue Act of 1942, c. 619, 56 Stat. 798] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business . . .

* * * * * * * * *

(n) *Basis for Depreciation and Depletion.*—The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be as provided in section 114.

* * * * * * * *

(26 U.S.C. 1946 ed., Sec. 23.)

Sec. 113. Adjusted Basis for Determining Gain or Loss.

(a) *Basis (Unadjusted) of Property.*—The basis of property shall be the cost of such property; except that —. . .

* * * * * * * *

(8) *Property Acquired by Issuance of Stock or as Paid-In Surplus.*—If the property was acquired after December 31, 1920, by a corporation—

(A) by the issuance of its stock or securities in connection with a transaction described in section

112(b)(5) (including, also, cases where part of the consideration for the transfer of such property to the corporation was property or money, in addition to such stock or securities), or

(B) as paid-in surplus or as a contribution to capital,

then the basis shall be the same as it would be in the hands of the transferor, increased in the amount of gain or decreased in the amount of loss recognized to the transferor upon such transfer under the law applicable to the year in which the transfer was made.

* * * * * * *

(b) *Adjusted Basis.*—The adjusted basis for determining the gain or loss from the sale or other disposition of property, whenever acquired, shall be the basis determined upon subsection (a), adjusted as hereinafter provided.

* * * * * * *

(26 U.S.C. 1946 ed., Sec. 113)

Sec. 114. Basis for Depreciation and Depletion.

(a) *Basis for Depreciation.*—The basis upon which exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the adjusted basis provided in section 113(b) for the purpose of determining the gain upon the sale or other disposition of such property.

* * * * * * *

(26 U.S.C. 1946 ed., Sec. 114.)

Sec. 115. Distributions by Corporations.

(a) *Definition of Dividend.*—The term "dividend" when used in this chapter . . . means any distribution made by a corporation to its shareholders, whether in

money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made . . .

(b) *Source of Distributions.*—For the purposes of this chapter every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. Any earnings or profits accumulated, or increase in value of property accrued, before March 1, 1913, may be distributed exempt from tax, after the earnings and profits accumulated after February 28, 1913, have been distributed, but any such tax-free distribution shall be applied against and reduce the adjusted basis of the stock provided in section 113 . . .

. . . . . .

Sec. 712. Excess Profits Credit—Allowance [Added by Sec. 201, 2nd 1940 Act; amended by Sec. 13, Excess Profits Tax Amendments of 1941].

(a) *Domestic Corporations.*—In the case of a domestic corporation which was in existence before January 1, 1940, the excess profits credit for any taxable year shall be an amount computed under section 713 or section 714, whichever amount results in the lesser tax under this subchapter for the taxable year for which the tax under this subchapter is being computed. In the case of all other domestic corporations the excess profits credit for any taxable year shall be an amount computed under section 714. (For allowance of excess profits credit in case of certain reorganizations of corporations, see section 741.)

. . . . . .

(26 U.S.C. 1946 ed., sec. 712(a))

Sec. 714. Excess Profits Credit—Based on Invested Capital.

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is:	The credit shall be:
Not over $5,000,000	8% of the invested capital
Over $5,000,000	$400,000, plus 7% of the excess over $5,000,000.

(as in force during fiscal year ended October 31, 1942)

Sec. 714. Excess Profits Credit—Based on Invested Capital. [as amended by Section 217, Revenue Act of 1942]

The excess profits credit, for any taxable year, computed under this section, shall be the amount shown in the following table:

If the invested capital for the taxable year, determined under section 715, is:	The credit shall be:
Not over $5,000,000	8% of the invested capital.
Over $5,000,000, but not over $10,000,000	$400,000, plus 7% of the excess over $5,000,000.
Over $10,000,000, but not over $200,000,000	$750,000, plus 6% of the excess over $10,000,000.
Over $200,000,000	$12,150,000, plus 5% of the excess over $200,000,000.

(as in force during fiscal year ended October 31, 1943)

Sec. 718. [As added by Sec. 201, Second Revenue Act of 1940, supra] Equity Invested Capital.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b),—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) *Property Paid In.*—Property (other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined in the same manner as if the property were still held at the beginning of such taxable year. If such unadjusted basis is a substituted basis it shall be adjusted, with respect to the period before the property was paid in, in the manner provided in section 113(b)(2);

* * * * * * *

(4) *Earnings and Profits at Beginning of Year.*—The accumulated earnings and profits as of the beginning of such taxable year;

* * * * * * *

(as in force during fiscal year ended October 31, 1942)

Sec. 718. [As added by Sec. 201, Second Revenue Act of 1940, supra] Equity Invested Capital.

(a) *Definition.*—The equity invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following amounts, reduced as provided in subsection (b)—

(1) *Money Paid In.*—Money previously paid in for stock, or as paid-in surplus, or as a contribution to capital;

(2) [as amended by Sec. 218, Revenue Act of 1942, c. 619, 56 Stat. 798] *Property Paid In.*—Property

(other than money) previously paid in (regardless of the time paid in) for stock, or as paid-in surplus, or as a contribution to capital. Such property shall be included in an amount equal to its basis (unadjusted) for determining loss upon sale or exchange. If the property was disposed of before such taxable year, such basis shall be determined under the law applicable to the year of disposition, but without regard to the value of the property as of March 1, 1913. If the property was disposed of before March 1, 1913, its basis shall be considered to be its fair market value at the time paid in. If the unadjusted basis of the property is a substituted basis, such basis shall be adjusted, with respect to the period before the property was paid in, by an amount equal to the adjustments proper under section 115(l) for determining earnings and profits;

* * * * * * *

(4) *Earnings and Profits at Beginning of Year.*— The accumulated earnings and profits as of the beginning of such taxable year;

* * * * * * *

(as in force during fiscal year ended October 31, 1943)

Sec. 728. Meaning of Terms Used [Added by Sec. 201, 2nd 1940 Act].

The terms used in this subchapter shall have the same meaning as when used in Chapter 1.

TREASURY REGULATIONS

Treasury Regulations 103, issued under the Internal Revenue Code, as in effect during the taxable year ended October 31, 1942:

Sec. 19.113(a)(8)-1.[23] *Property acquired by a corporation after December 31, 1920.*— . . .

[23] Section 29.113(a)(8)-1 of Treasury Regulations 111, promulgated under the Internal Revenue Code, as in effect during the taxable year ended October 31, 1943, is identical with Section 19.113(a)(8)-1 of Regulations 103.

In respect of property acquired by a corporation after December 31, 1920, from a shareholder as paid-in surplus, or from any person as a contribution to capital, the basis of the property in the hands of the corporation is the basis which the property would have had in the hands of the transferor if the transfer had not been made. In the case of property acquired by a corporation after December 31, 1920, as a gift the basis thereof shall be determined under section 113(a)(2).

* * * * * * * * *

Sec. 19.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and mere bookkeeping entries increasing or decreasing surplus will not be conclusive. Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section. Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

easury Regulations 111, promulgated under the Internal venue Code, as in effect during the taxable year ended tober 31, 1943:

Sec. 29.115-3. *Earnings or Profits.*—In determining the amount of earnings or profits (whether of the taxable year, or accumulated since February 28, 1913, or accumulated prior to March 1, 1913) due consideration must be given to the facts, and, while mere bookkeeping entries increasing or decreasing surplus will not be con-

clusive, the amount of the earnings or profits in any case will be dependent upon the method of accounting properly employed in computing net income. For instance a corporation keeping its books and filing its income tax returns under sections 41, 42, and 43 on the cash receipts and disbursements basis may not use the accrual basis in determining earnings and profits; a corporation computing income on the installment basis as provided in section 44 shall, with respect to the installment transactions, compute earnings and profits on such basis; and an insurance company subject to taxation under section 204 shall exclude from earnings and profits that portion of any premium which is unearned under the provisions of section 204(b)(5) and which is segregated accordingly in the unearned premium reserve.

Among the items entering into the computation of corporate earnings or profits for a particular period are all income exempted by statute, income not taxable by the Federal Government under the Constitution, as well as all items includible in gross income under section 22(a) or corresponding provisions of prior Revenue Acts. Gains and losses within the purview of section 112 or corresponding provisions of prior Revenue Acts are brought into the earnings and profits at the time and to the extent such gains and losses are recognized under that section (see section 29.115-12). Interest on State bonds and certain other obligations, although not taxable when received by a corporation, is taxable to the same extent as other dividends when distributed to shareholders in the form of dividends.

Treasury Regulations 109, promulgated under the Internal Revenue Code, as in force during the taxable year ended October 31, 1942:

Sec. 30.718-1.[24] *Determination of daily equity invested capital—Money and property paid in.*— . . .

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[24] Section 35.718-1 of Treasury Regulations 112, promulgated under the Internal Revenue Code, as in force during the taxable year ended October 1, 1943, is identical with Section 30.718-1 of Regulations 109.

If the property was acquired after December 31, 1920, by a corporation from a shareholder as paid-in surplus or from any person as a contribution to capital, then the basis shall be the same as it would be in the hands of the transferor if the transfer had not been made. (See section 113(a)(8).)

Sec. 30.718-2. *Determination of daily equity invested capital—Accumulated earnings and profits*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 30.718-4 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. . . .

Treasury Regulations 112, promulgated under the Internal Revenue Code, as in force during the taxable year ended October 31, 1943:

Sec. 35.718-2. *Determination of Daily Equity Invested Capital—Accumulated Earnings and Profits.*—(a) *In general.*—The term "accumulated earnings and profits" is not defined in the Internal Revenue Code. See, however, section 115 and the regulations prescribed thereunder as to the effect of certain transactions on earnings and profits, and section 35.718-5 as to the effect of the declaration and distribution of dividends. In general, the concept of "accumulated earnings and profits" for the purpose of the excess profits tax is the same as for the purpose of the income tax. . . .

NEW YORK STOCK CORPORATION LAW

Section 58 of the Stock Corporation Law of the State of New York, as amended in 1938 and 1939 c. 59 of the Consolidated Laws of New York:

No stock corporation shall declare or pay any dividend which shall impair its capital, nor while its capital

is impaired, nor shall any such corporation declare or pay any dividend or make any distribution of assets to any of its stockholders, whether upon reduction of the number or par value of its shares or of its capital, unless the value of its assets remaining after the payment of such dividend, or after such distribution of assets, as the case may be, shall be at least equal to the aggregate amount of its debts and liabilities, including capital.

(5030)